

Glenn Stevens: Recent developments

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to Western Sydney Business Connection, Sydney, 9 June 2010.

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Thank you for the invitation to be here today in western Sydney, a region which accounts for about one in every 15 people employed in Australia.

Of course events far from western Sydney can affect all of us here, through various channels. In view of the developments in recent weeks in Europe, it seems sensible to devote some time to what has occurred, and to what it may mean for Europe itself, for the global economy and of course for Australia. I should stress at the outset though that any assessment is very much preliminary at this stage.

To begin, let me sketch some background on the global economy.

We estimate that world GDP grew by around 1 per cent, or perhaps a little more, in the March quarter of this year. This was the third consecutive quarter of growth of about that pace after the contraction in the first half of 2009. Note that this occurred with very little contribution from the euro area, a region in which domestic demand contracted over the past two quarters.

Many respectable forecasters have pencilled in a growth rate for 2010 as a whole of 4 per cent or a bit more – that is, they have expected that the sort of the growth already seen for the past nine months or so would continue for the rest of this year. This would be close to, or slightly above, the average pace of growth for the global economy over the ten years up to 2008.

This is not just the Reserve Bank's forecast – though we broadly concur with it at this stage. The IMF, the OECD and various private forecasters have numbers like this. There are some who are more pessimistic, though there have also been others somewhat more optimistic. It is worth noting, by the way, that this outcome would be noticeably better than what was expected a year ago. For most of the intervening period the bulk of commentators seem to have been worried by “downside risks” – that is the possibility that things could turn out worse than expected. But it was the “upside” risks that, in fact, materialised over that period.

One reason for that may be that all countries responded to the events of late 2008 by moving their macroeconomic policies in an expansionary direction. Just as the downturn in October 2008 was highly synchronised, so was the policy reaction. In countries that have not had an impaired banking system, those policy reactions have had a considerable effect. They were, amplified by the spill-overs that occurred because the stimulus took place in all countries more or less at the same time.

Yet the upswing is uneven. It has been very strong in Asia and Latin America, moderate so far in the US and weak overall in Europe (which itself has quite a mix of growth performances across countries).

Of importance to Australia is that the strongest growth in demand has been nearby. Apart from Japan most of the economies in the east Asian region have experienced a “v-shaped recovery”. While some of this recovery reflects the process of re-stocking of durable goods around the world, it also reflects strong demand within the region.

Commodity prices generally rose somewhat after the very large falls in late 2008. But of significance for Australia, prices for those resources which serve as the raw materials for steel production in particular have been exceptionally strong. Prices for iron ore and coal rebounded very sharply during 2009 and early 2010. Contract prices for iron ore in the

current period are double those of a year ago; until recently spot prices were well above even that level though they have retreated somewhat of late.

In short, global growth, while uneven, has been recovering in the places and in the form that was most likely to deliver a boost to Australia's terms of trade. It looks like our terms of trade this year will again reach the 50-year high seen two years ago.

It could, of course, be that some of this recent increase in prices turns out not to be permanent. Some economies in Asia will probably, one way or another, experience a moderation in the pace of expansion over the coming year, because the pace of growth over the past year can't be sustained without problems arising. The Chinese authorities have been seeking for some months to take the steam out of certain sectors of their economy, particularly housing prices. They may be having some success. For this and other reasons, we and other forecasters are assuming that this peak in the terms of trade won't be sustained.

But to reach that 50-year high twice in three years would appear to signal that something pretty important has been going on – something more than just temporary cyclical events. It is increasingly apparent that the Asian region is becoming large enough that it has a tangible independent impact on the global economy and on Australia in particular. China and non-Japan east Asia together accounted for around 9 per cent of the world economy in 1990. By 2000, their share was around 14 per cent. In 2010, it is likely to be about 20 per cent. China is already the world's largest steel producer and the second largest user of oil after the United States. China's share of global GDP¹ could exceed that of the euro area within another five years.

This confluence of events is likely to see an acceleration in the shift in perceptions about the shape of the global economy and financial system. The prominence of Asian views, and the weight accorded to them, are likely to grow accordingly. What Asian policy makers do and say increasingly matters.

Turning then to the recent events in Europe, it is worth asking at the outset how these countries arrived at their current position. The story has many nuances by country but broadly, the public debt relative to GDP has long tended to be on the high side in Europe. It generally ratcheted up in successive economic downturns over the past three or four decades and efforts to get it down in the good times had only modest success. For some countries that joined the euro area the substantial fall in borrowing costs they enjoyed masked a degree of vulnerability, in that their fiscal sustainability depended partly on being able to continue borrowing cheaply. Demographic trends – pronounced in Europe, with some countries already experiencing declining populations – further highlight the problem. A high debt burden is much more easily managed in countries with higher potential growth prospects, one driver of which is population growth.

This problem was slowly but steadily accumulating over many years. Then the financial crisis occurred. There was a deep recession from which recovery is not yet entrenched. Budget deficits rose sharply as a result – reaching 10 per cent of annual GDP or more in a number of instances. The prospect of adding that much to the debt stock each year for even just a few years can make a difference to assessments of sustainability even for strong countries. For the not-quite-so-strong cases, markets began to signal unease. Borrowing costs rose for those countries, which of course makes the fiscal situation worse. And so on.

Initially the effect of these developments on financial markets was very much confined to Europe. Wider effects were observed in May as global investors became more cautious. Uncertainty over the nature of the policy response, and fears that it could be un-coordinated

¹ Measured on a Purchasing-Power-Parity basis.

across countries, saw a marked increase in volatility in share prices and exchange rates. Our own markets have been affected along with everyone else's.

Qualitatively, some of the market events had a little of the flavour of September and October 2008 about them. *Quantitatively*, however, they have, at this point, been nothing like as pronounced. Indicators of stress in markets have not, to date, signalled anything like the problems of late 2008 when interbank and capital markets seized up. But of course the episode is not yet over, and the issues will continue to need careful handling by all concerned and close monitoring by the rest of us.

European authorities have responded by assembling a large support package, which covers Greece but, if needed, other countries too. It has several elements. It provides European level financing for individual governments – so relieving them of the need to go to private capital markets – for a period of time, subject to conditions. The European Central Bank is undertaking some operations to stabilise dysfunctional bond markets and is ensuring abundant liquidity in money markets. The IMF has also committed to make funds available and will play a role in ensuring conditionality requirements are met. The final element is that governments are committing to reduce budget deficits and thus control the future rise of debt, though debt will keep increasing for a few years. Of course much detail remains to be set out as to how the mechanics of the package will work.

At this stage any assessment about the impact of these events on the economies of Europe and on those further afield is very preliminary. One might expect some effect on business and household confidence, but it is too early to see much evidence of that yet.

Looking ahead, we would have to expect that the planned fiscal contractions will dampen European demand as they occur, which in some cases will be over a number of years. Now some such effects should already have been embodied in existing projections since fiscal consolidation has been planned all along. But with some euro area countries now intending to do more consolidation in the near term than they had earlier planned, the dampening effects will occur sooner than earlier assumed (though this presumably improves growth prospects in a few years' time compared with the earlier forecast). The alternative path of less fiscal action would carry less risk of near-term weakness in demand. However in the current climate it could also have an attendant risk of loss of fiscal credibility. If the latter occurred, it could be followed in short order by a serious crisis that would push up borrowing costs sharply for both governments and private borrowers, so damaging growth.

So a path involving a credible fiscal consolidation has to be found that steers between these two possible bad outcomes. That task has become more difficult. Over the horizon of a couple of years it is hard to see how euro area demand won't be weakened. All other things equal, that would lessen global growth in 2011 compared with earlier projections (although it must be said that those projections have not relied all that much on growth in the euro area).

Of course, all other things won't be equal. Financial markets and, perhaps, policymakers will respond to these events. The decline in long-term interest rates in the core European countries and many other countries around the world that has occurred may work, if it is sustained, to lessen the adverse impact on growth in those countries. If policymakers in other regions responded to the potential euro area weakness by leaving policies easier than they would otherwise have been, this too would have some offsetting impact, though possibly at the cost of more unbalanced growth.

As to the effects on Australia, the euro area takes only about 5 per cent of Australia's exports. Those exports have been declining over the past few years anyway because the euro area has been weak for a while. So that direct effect doesn't seem likely to be all that large. It is usually the case, however, that the most important impacts on Australia from these sorts of events are not the direct export effects but those that come through the broader global channels – the impact on world and Asian growth, on resource prices and on the cost and availability of global capital.

How big those effects may turn out to be remains to be seen. But one thing we can say is that one of the most important advantages in coping with episodes such as this is a good starting point. There is an old joke about the best way to get somewhere involving “not starting from here”. We are not starting from the same place as Europe. In particular, Australia’s budgetary position is very different from those in Europe and, for that matter, most countries. Public debt is low and budget deficits are under control and already scheduled to decline. The banking system is in good shape with little exposure to the European sovereigns having the biggest problems, and asset quality is generally better than had been expected. The flexibility afforded by our floating currency, coupled with credible monetary and fiscal policies, are all advantages in periods of global uncertainty. This doesn’t mean there will be no effects. But these factors put us in the best position to ride through this particular event, even if it does get worse.

Stepping back from the immediate issues, a final question worth posing is: what lessons might we take away from watching the travails in Europe?

One is that vulnerabilities can remain latent for a long time, then materialise very rapidly. Markets can happily tolerate something for an extended period without much reaction, then suddenly react very strongly as some trigger brings the issue into clearer focus. There were certainly significant revelations about the true financial position in Greece that occasioned additional concern, but more generally in Europe it can’t really have been news that the state of public finances was an issue: it had been so for years. But governments didn’t come under gradually increasing market pressure to fix the problem – the pressure was minimal for a long time, then it suddenly became intense after a trigger event, in this case an economic downturn.

It follows that potential vulnerabilities need to be addressed in good times, even when markets are not signalling unease, because by the time markets take notice and start responding seriously – which will usually be in bad times – the problem may have become pretty big.

How is this relevant to Australia?

Australia does not have a problem with public debt, as I have already said. Nor do we have a problem with corporate debt. Some highly leveraged entities foundered over the past couple of years but most of the corporate sector had pretty strong balance sheets going into the downturn and they are even stronger now.

The big rise in debt in the past couple of decades has been in the household sector. There have been many reasons for that and, overwhelmingly, households have serviced the higher debt levels very well. The arrears rates on mortgages, for example, remain very low by global standards. As a result the asset quality of financial institutions has remained very good. **So, to be clear, my message is not that this has been a terrible thing.**

But that doesn’t mean it would be wise for that build-up in household leverage to continue unabated over the years ahead. One would have to think that, however well households have coped with the events of recent years, *further* big increases in indebtedness could increase their vulnerability to shocks – such as a fall in income – to a greater extent than would be prudent.

It may be that many households have sensed this. We see at present a certain caution in their behaviour: even though unemployment is low, and measures of confidence have been quite high, consumer spending has seen only modest growth. This may be partly attributable to the fact that the stimulus measures of late 2008 and early 2009 resulted in a bringing forward of spending on durables into that period from the current period (though purchases of motor vehicles by households – a different kind of durable – have increased strongly over recent months). But the long downward trend in the saving rate seems to have turned around and I think we are witnessing, at least just now, more caution in borrowing behaviour. Of course this will have been affected by the recent increase in interest rates but the level of

rates is not actually high by the standards of the past decade or two. We can't rule out something more fundamental at work.

We can't know whether this apparent change will turn out to be durable. But if it did persist, and if that meant that we avoided a further significant increase in household leverage in this business cycle, it might be no bad thing. Moreover if a period of modest growth in consumer spending helped to make room for the build-up in investment activity that seems likely, perhaps that would be no bad thing either.

These sorts of trends would surely increase the medium-term resilience of household finances and accommodate the resource boom and the rise in other forms of investment with less pressure on labour markets and prices than otherwise.

The world economy has to date staged a stronger recovery than most thought likely a year ago, albeit one that is uneven across regions. Looking ahead, it has to be expected that the unfolding situation in Europe, which is going to result in earlier fiscal tightening than had been assumed by forecasters until now, will weigh somewhat on global growth in 2011. But the overall outcome will depend on what else happens and judgements about all that at this stage can only be preliminary. It cannot be denied that the potential for further financial turmoil exists, but to date the stresses have not been of the order of magnitude we saw a year and a half ago. Much still hinges, however, on the way European policy makers craft their ongoing response to a complex problem.

We in Australia must naturally keep a careful watch on all this. It will be just as important, though, to keep a close watch on developments in the Asian region. Asia will be affected by events in Europe, but also by domestic forces. The experience of the past few years is that those domestic factors – good or bad – can loom just as large as ones further afield when it comes to Asia's economic performance and, therefore, our own. In the final analysis, sensible and credible policies at home, the strength of our financial institutions and the resilience and adaptability of the businesses and employees that make up the Australian economy, will continue to be our greatest assets.